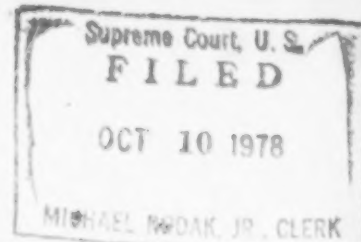


No. 78- 607



IN THE
Supreme Court of the United States
OCTOBER TERM, 1978

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE
OF CALIFORNIA, ET AL., *Respondents.*

**PETITION FOR A WRIT OF CERTIORARI TO THE
SUPREME COURT OF THE STATE OF CALIFORNIA**

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October 1978



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THE PUBLIC UTILITIES COMMISSION OF THE STATE
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**PETITION FOR A WRIT OF CERTIORARI TO THE
SUPREME COURT OF THE STATE OF CALIFORNIA**

General Telephone Company of California petitions for a writ of certiorari to review a final judgment of the Supreme Court of California sustaining a rate-making order of the California Public Utilities Commission.

OPINIONS BELOW

The Supreme Court of California wrote no opinion. The opinion of the Public Utilities Commission, which is not yet reported, appears at Appendix B to this petition.¹

¹ The appendices are separately bound in a companion volume, cited as "App.," which serves both this petition and the petition filed here by The Pacific Telephone and Telegraph Company.

JURISDICTION

The judgment of the court below, in the form of an order denying a petition for review of a ratemaking decision of the Public Utilities Commission, was entered on July 13, 1978. (App. A.) This order is a judicial decision on the merits of all issues including the federal questions raised both in the state court review proceeding and before the PUC. *Napa Valley Electric Co. v. Railroad Comm'n*, 251 U.S. 366 (1920); *People v. Western Air Lines, Inc.*, 42 Cal. 2d 621, 630, 268 P.2d 723, 728, *appeal dismissed*, 348 U.S. 859 (1954). This Court's jurisdiction is invoked under 28 U.S.C. § 1257(3).

QUESTION PRESENTED

Whether the California Public Utilities Commission and the Supreme Court of California misconstrued Sections 167(1) and 46(f)(2) of the Internal Revenue Code in concluding, contrary to the ruling of the Internal Revenue Service, that methods of accounting prescribed by the Commission for ratemaking purposes, which pass through to consumers in reduced rates a portion of the federal tax benefits resulting from the use of accelerated depreciation and the investment tax credit, do not prevent the affected utilities from meeting the conditions of eligibility for those benefits prescribed by the Internal Revenue Code.²

² This case also presents the question whether the decision of the California Supreme Court deprives the affected utilities of their property without due process of law in violation of the Fourteenth Amendment. This question is fully briefed in the companion petition filed by The Pacific Telephone and Telegraph Company. General joins Pacific in presenting the question to the Court.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954, as amended, 26 U.S.C. §§ 167(l) and 46(f), are reprinted in Appendix C along with the applicable Treasury Regulations, 26 C.F.R. §§ 1.167(l)-1(h)(1) and (6).

STATEMENT

The California Public Utilities Commission in fixing intrastate telephone rates has adopted novel methods for treating the federal income tax benefits of accelerated depreciation and the investment tax credit. The Commission's ratemaking order is expressly premised on its conclusion that the treatment it has prescribed is consistent with the sections of the Internal Revenue Code that govern eligibility for these tax benefits. In fact, the treatment prescribed by the Commission is inconsistent with the relevant Code provisions. The Internal Revenue Service itself has so ruled upon specific consideration of the Commission's order. Nevertheless, the California Supreme Court has sustained the Commission's order.

The consequences of the California court's decision are nothing short of disastrous. The immediate effect will be to render the telephone companies involved—petitioner General Telephone Company of California and The Pacific Telephone and Telegraph Company—ineligible to claim the very tax benefits assumed by the Commission in its order. Their ineligibility will be retroactive, in General's case to 1970, and will expose them to a combined current liability for back taxes of well over \$1 billion. Their ultimate tax liability may exceed \$2 billion.

As the Commission itself recognized in its order, the satisfaction of such a massive liability would cause severe financial hardship for General and Pacific, lead to a significant deterioration in telephone service in California, and necessitate "staggering" rate increases for the state's telephone users. If the California commission's novel methods are adopted by other state regulatory agencies, the consequences for public utilities and their customers in those states will be equally devastating. The federal interests embodied in the applicable Code sections will be significantly impaired. Only review by the Court at this time can avert these consequences.

A. The Statutory Background

Two Internal Revenue Code provisions are involved. Section 167(l) limits the permissible treatment in utility ratemaking of the tax deferral benefits of accelerated depreciation. Section 46(f) similarly limits the permissible ratemaking treatment of the benefits of the investment tax credit.

1. Accelerated Depreciation

The developments that moved Congress to add Section 167(l) to the Internal Revenue Code in 1969 have been described by this Court in *FPC v. Memphis Light, Gas & Water Division*, 411 U.S. 458, 459-61 (1973). In brief: Section 167 of the Code as enacted in 1954 authorized taxpayers, including regulated utilities, to use accelerated or liberalized depreciation methods in calculating their federal income taxes. A company using an accelerated method of depreciation writes off the value of an asset at a greater rate in the early years of its life than in later years. In contrast,

a company using ordinary straight-line depreciation writes off the value of an asset at an even rate over its service life. The effect of accelerated depreciation is to defer tax payments, which makes available for investment funds that would otherwise have been paid in taxes. The purpose of Congress was to encourage companies to expand or modernize their plant and equipment. As originally enacted, Section 167 contained no special provisions governing the way in which the deferred tax payments resulting from a public utility's use of accelerated depreciation were to be treated by the utility and its regulatory agency for ratemaking purposes. Federal income taxes are properly included as an expense in a utility's cost of service for such purposes. 411 U.S. at 460.

There are two alternative methods of accounting open to a utility that uses accelerated depreciation: "flow-through" and "normalization." *See* 411 U. S. at 460. Under flow-through accounting, the utility's rates are calculated on the basis of the reduced taxes currently paid by it. Current ratepayers thereby receive the benefit of accelerated depreciation in the form of lower rates; the utility derives no funds to use for investment in plant and equipment. Under normalization accounting, the utility is treated as if its current taxes were based on straight-line depreciation, which if actually used by the utility would result in higher taxes. The difference between the higher taxes based on straight-line depreciation and the taxes actually paid is placed in a reserve for deferred taxes that is available to the utility for investment. Only under normalization accounting does a utility that uses accelerated depreciation have the same incentive and means as an unregulated business to invest in plant and equipment.

The California Public Utilities Commission determined in 1960 that a utility's decision whether to take accelerated depreciation was a matter of managerial discretion, but that a utility that elected accelerated depreciation must use the flow-through method of accounting for ratemaking purposes. *Tax Treatment of Accelerated Depreciation*, 33 P.U.R.3d 209 (Cal. P.U.C. 1960). A number of other regulatory agencies took similar action. General and Pacific, which is the California Bell System affiliate, elected to continue to use straight-line depreciation for tax purposes, as well as for all their other accounting and regulatory purposes, and so were not affected by the California PUC's 1960 decision. In 1968, however, the PUC decided that it would impute to a utility the use of accelerated depreciation for ratemaking purposes regardless of the method actually used by the utility in computing taxes. *Pacific Tel. & Tel. Co.*, 69 Cal. P.U.C. 53, 77 P.U.R.3d 1 (1968); *General Tel. Co. of Cal.*, 63 Cal. P.U.C. 601, 80 P.U.R.3d 2 (1969).

When Congress considered tax reform legislation in 1969, legislators were concerned over the loss of tax revenues resulting from the combined effect of accelerated depreciation for computing federal taxes and flow-through for fixing rates. 411 U.S. at 461. The use of accelerated depreciation itself increases a company's deductions from income and leaves it with less net income on which to pay taxes. If, in the case of a utility, rates are then reduced in order to "flow through" to ratepayers the reduction in taxes arising from the use of accelerated depreciation, the utility's taxable income is further depressed. And there is no compensating gain. None of what Congress hoped to achieve in the way of encouraging capital investment is achieved

when utilities are made to pass the benefits of accelerated depreciation through to their current customers. H.R. Rep. No. 91-413, 91st Cong., 1st Sess., pt. 1 at 131-32 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 172 (1969). An immediate and serious threat to the federal revenue, and to the federal policy embodied in Section 167, was posed by the possibility that other regulatory agencies would follow the lead of the California PUC in imputing the use of accelerated depreciation with flow-through to companies that had been using straight-line depreciation—thereby compelling those utilities to switch to accelerated depreciation and pass the benefits through to their customers.

Congress passed Section 167(l) in response to these concerns. Tax Reform Act of 1969, § 441(a), 83 Stat. 487. Section 167(l) is clear and simple in its command that companies such as General and Pacific, companies that had not previously used accelerated depreciation or formally applied for permission to do so, cannot switch to accelerated depreciation unless they use the normalization method of accounting for ratemaking purposes. Even so conditioned, the privilege of switching to accelerated depreciation is available only as to property acquired after 1969. Int. Rev. Code § 167(l)(2)(B). The statute is equally clear as to what is meant by “normalization method of accounting.” Utilities electing to use accelerated depreciation for tax purposes will use straight-line depreciation in calculating their depreciation and tax expenses for ratemaking purposes and “must make adjustments to a reserve to reflect the deferral of taxes resulting from the use” on their tax return of an accelerated method of depreciation. Int. Rev. Code § 167(l)(3)(G). (App. C, pp. 82A-83A.)

2. Investment Tax Credit

The investment tax credit is a credit against tax equal to a percentage of the value of eligible goods placed in service in a year. When it was reintroduced into the tax code by the Revenue Act of 1971, § 105(c), 85 Stat. 497, after having been repealed by the Tax Reform Act of 1969, Congress saw that it offered the same temptation as accelerated depreciation to state regulatory agencies to insist that utilities pass through to ratepayers at once the full benefit of the credit. If the credit is passed through, it does not offer the intended incentive to expand or modernize plant.

Section 46(f) of the Code (originally Section 46(e)) was enacted in response to this concern. H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 26 (1971); S. Rep. No. 92-437, 92d Cong., 1st Sess. 39 (1971). Paragraph (2) of Section 46(f), applicable in General's (and Pacific's) case,³ provides that no investment credit will be allowed with respect to any public utility property if (a) the utility's cost of service for ratemaking purposes is reduced by more than a ratable portion of the allowable credit over the useful life of the property or (b) the utility's rate base for ratemaking purposes is reduced by reason of any portion of the allowable credit. (App. C, p. 76A.)⁴

³ Section 46(f)(2) states a special rule that is applicable in lieu of the general rule of § 46(f)(1) when a taxpayer makes an election thereunder. General made such an election.

⁴ Generally speaking, a utility's rates are determined in rate-making proceedings by reference to its expenses of doing business and its rate base (which is the value of its property devoted to public use). Rates are set high enough to cover the utility's cost of service, which includes its itemized expenses of doing business and a reasonable return on its investment. (The latter is determined by applying a percentage rate of return to the utility's rate

B. The Public Utilities Commission Proceedings

Following the enactment of the Tax Reform Act of 1969, General and Pacific each elected to use accelerated depreciation for tax purposes with respect to property acquired after 1969. The PUC issued interim decisions that for the period beginning January 1, 1970, Pacific and General could use accelerated depreciation and could normalize tax expense. *Pacific Tel. & Tel. Co.*, 71 Cal. P.U.C. 590 (1970); *General Tel. Co. of Cal.*, 71 Cal. P.U.C. 657 (1970). In 1971, General received a rate increase in a case in which its cost of service was based on accelerated depreciation with normalization. *General Tel. Co. of Cal.*, 72 Cal. P.U.C. 652, 92 P.U.R. 3d 224 (1971).

Four days later, the California Supreme Court annulled the PUC's interim ruling as to accelerated depreciation in Pacific's case, holding that the PUC had erred in failing to consider alternatives to normalization that would be more favorable to current ratepayers and remanding to it for such consideration. *San Francisco v. Public Utilities Comm'n*, 6 Cal.3d 119, 490 P.2d 798, 98 Cal.Rptr. 286 (1971). The PUC thereupon ordered a rehearing of General's rate case limited to the issue of the appropriate allowance for tax depreciation to be adopted for ratemaking purposes. *General Tel. Co. of Cal.*, 72 Cal. P.U.C. 725 (1971).

base.) Higher expenses, therefore, necessitate higher rates. Likewise, a larger rate base requires a greater amount of revenue, for the utility to earn a reasonable rate of return on its property. A regulatory commission that seeks to lower rates, and thereby pass through to a utility's customers all or part of the tax benefits of the investment tax credit (or accelerated depreciation), can achieve this by reducing either the utility's computation of expenses or its computation of rate base.

Three years later, following the rehearing, the PUC *again* held that General would not qualify for accelerated depreciation under the federal tax laws if the agency were to use other than a normalization method in fixing General's rates. *General Tel. Co. of Cal.*, 77 Cal. P.U.C. 558 (1974). At the same time, in deciding a separate rate increase application of General's, the PUC reaffirmed that position and adopted a ratable cost-of-service reduction for the investment tax credit, in compliance with Section 46(f)(2) of the Code.⁵ *General Tel. Co. of Cal.*, 77 Cal. P.U.C. 590 (1974).

Late in 1975, the California Supreme Court annulled the two 1974 PUC orders respecting General insofar as the treatment of accelerated depreciation and the investment credit was concerned and the corresponding part of a 1974 PUC decision respecting Pacific. *City of Los Angeles v. Public Utilities Comm'n*, 15 Cal. 3d 680, 542 P.2d 1371, 125 Cal. Rptr. 779 (1975). The court once more remanded for consideration of alternatives to "normalization," on the one hand, and "flow-through" on the other.

C. The Public Utilities Commission Decision

The PUC made its decision on this further remand by a divided vote on September 13, 1977. The Commission stressed at the outset that the continued eligibility of General and Pacific for the benefits of accelerated

⁵ The PUC in the same decision approved the application of normalization accounting to General's use of the asset depreciation range and class life systems of depreciation. Essentially the same federal normalization requirements govern General's eligibility to depreciate property in accordance with these systems as its eligibility to use accelerated depreciation. Treas. Reg. §§ 1.167(a)-11 (b)(6)(ii), 1.167(a)(1)-12(a)(4)(iii)(b); and eligibility is affected in the same way by the decision below.

depreciation and the investment credit was its foremost consideration. "Eligibility is the first issue to be determined," the Commission said. It concluded that a loss of eligibility would create service problems and "staggering financial problems to be ultimately borne by the ratepayers whose interests we are attempting to redress." Therefore, it said, "[w]e believe that eligibility for these tax benefits should be maintained and proceed on this basis." (App. B, p. 22A.)

On that basis the Commission devised methods of treating accelerated depreciation and the investment credit for ratemaking purposes that it contended—quite wrongly, we submit—would meet the statutory requirements:

"The[se] methods . . . maintain the eligibility of the utilities to use accelerated depreciation and ITC and comply with the requirements of the Internal Revenue Code relating to Pacific and General." (App. B, pp. 49A-50A.)

The revenue and expense calculations underlying the rates the Commission prescribed assumed the availability of the tax benefits to the companies. That assumption was erroneous. As the Internal Revenue Service has ruled upon consideration of the PUC decision, the use of these methods destroys eligibility because they do not result in normalization in the one case or in an allowable ratable reduction in the other.

The "AAA" Method. For dealing with accelerated depreciation the PUC devised a method called "averaged annual adjustment" or "AAA." Contrary to the PUC's contention, this is not a normalization method within the meaning of the Code. It therefore destroys the eligibility for accelerated depreciation of a utility compelled to use it. The AAA method takes advantage

of the fact that it is permissible and consistent with normalization to exclude from a utility's rate base an amount *equal* to its reserve for deferred taxes. H.R. Rep. No. 91-413, 91st Cong., 1st Sess. pt. 1 at 133 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 173 (1969). The theory is that the reserve is the equivalent of an interest-free loan, on which the utility need not be allowed a return. But it is not consistent with normalization as conceived by the Code and relevant Treasury Regulations to exclude from rate base an amount *greater* than the deferred tax reserve for the period used in determining a utility's cost of service. Int. Rev. Code § 167(l)(3)(G)(ii); Treas. Reg. § 1.167(l)-1(h)(6).

The AAA method results in such an excessive exclusion from rate base. Averaged annual adjustment reduces General's rate base in each ratemaking test year by the estimated average of the deferred tax reserve in the test year and the three succeeding years. According to the uncontroverted evidence of record, and the PUC's own estimate, in any foreseeable three-year period there will be substantial net additions to General's plant (App. B, pp. 58A-59A), which means a growing deferred tax reserve. Therefore, the technique of looking three years ahead in computing the deferred tax reserve necessarily results in a greater exclusion from rate base than is allowed by the relevant provisions of the Code and the Regulations. These provisions limit the permissible exclusion precisely because reducing a utility's rate base as the PUC has done results in lower rates (note 4, *supra*) and effectively, therefore, a flow-through of some of the benefits of accelerated depreciation.⁶

⁶ This point is developed at greater length at pp. 22-24 below.

The "2A" Method. For dealing with the investment tax credit, the PUC adopted an "annual adjustment" or "2A" method. All ratemaking elements—costs, revenues and rate base—are frozen at test-year levels except for the investment credit, which is adjusted each year to reflect prospective capital additions for the coming year. Thus, the investment credit calculation is augmented by prospective capital additions, but the utility's rate base between test years does not include the very property that produces the augmentation, nor do the utility's costs include depreciation expense associated with such property.

As will be explained at greater length (pp. 25-26, *infra*), the defect in this method under Section 46(f)(2) is that matching higher year-2 investment credits against year-1 cost of service and rate base for ratemaking purposes in effect reduces cost of service "by more than a ratable portion" of the credit, Int. Rev. Code § 46(f)(2)(A), and impermissibly reduces rate base by not recognizing as a part of the base the year-2 additions that yield the investment credit. The result is that a part of the investment credit attributable to plant additions not recognized for any other ratemaking purpose is passed through to customers.

General's rates have been open and subject to refund since 1970. On the basis of its treatment of accelerated depreciation and the investment credit,⁷ the Commission ordered General to make refunds totaling \$65,440,000 (\$206,000,000 in Pacific's case) as of December 31, 1977, and for the future prescribed rates

⁷ In addition to applying the AAA method to property acquired by General since January 1, 1970, the Commission imputed accelerated depreciation with flow-through to property acquired by General in 1969. (App. B, pp. 33A-34A.)

that would yield to General \$12,653,000 a year less (\$60,000,000 in Pacific's case) than rates computed in conformity to the normalization and ratable flow-through requirements of the Code. (App. B, pp. 50A-52A.)

Two commissioners of the five-member PUC dissented from the decision adopting the AAA and 2A methods and directing the refunds and rate reductions. (App. B, pp. 71A-74A.) Two of the three majority commissioners wrote a separate opinion, blaming (the word is fairly used) others, mainly the California Supreme Court, for what the Commission had had to do, and urging a rapid decision by this Court on the issue of eligibility: "The *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be." (App. B, p. 70A.)

D. The Internal Revenue Service Position

General and Pacific each requested a ruling by the Internal Revenue Service concerning the effect of the PUC's decision on their eligibility for the federal tax benefits in question. The PUC had rejected a proposal that the effectiveness of its order be postponed for 180 days while such a ruling was sought. (App. B, pp. 39A-40A.) Efforts to encourage participation by the PUC staff in the IRS ruling proceedings were rebuffed by the PUC. (Decision No. 88215, December 6, 1977.) By a ruling in General's case dated June 9, 1978, the IRS held that the ratemaking treatment adopted by the PUC "would not be considered to be a proper normalization method of accounting" and that "[w]e believe the Commission's average annual adjustment method is a method to flow-through to the consumer in the form of lower rates a part of the reserve for deferred taxes."

(App. D, pp. 129A-130A.) Consequently, General would not be eligible to use an accelerated method of depreciation to compute its federal income tax liability.

Upon receipt of the Revenue Service's ruling, General asked the PUC to join it in requesting the court below (where petitions for review by then were pending) to remand the case to the PUC for further consideration of the issues in the light of the IRS ruling. The PUC declined, stating in response to a similar request by Pacific that the IRS ruling "adds nothing new to these proceedings." (Decision No. 88972, June 13, 1978.) On August 9, 1978, the IRS ruled that the treatment accorded the investment tax credit by the PUC would result in the loss by General of eligibility for the credit as well. (App. E.) Pacific received comparable rulings on both issues.⁸

E. The Court Below

General requested a rehearing of the PUC's decision, and the PUC denied the request. (Decision No. 88103, November 8, 1977.)⁹ General thereupon filed with

⁸ The IRS rulings in both General's and Pacific's cases are reprinted in Appendices D and E.

⁹ General had urged throughout the PUC proceeding that any ratemaking treatment that did not conform to the federal statutory conditions would disqualify it from using accelerated depreciation and the investment credit, that the use of such a disqualifying treatment while assuming eligibility would contravene the federal tax laws, and that such action would result in depriving General of property without due process of law in contravention of the Fourteenth Amendment. The PUC, premising its decision upon continued eligibility, found it unnecessary to discuss these issues. In its petition for rehearing, General explained at length how the accounting methods adopted by the PUC would result in General's disqualification and reiterated its arguments that the methods were illegal under the Internal Revenue Code and the Constitution. The PUC summarily denied the petition.

the California Supreme Court a petition for writ of review, asking the court to annul the PUC's decision. In its petition, General asserted that the PUC had misconstrued the governing provisions of federal law by prescribing methods of ratemaking accounting that did not conform to the conditions of eligibility prescribed by Sections 167(l) and 46(f)(2) of the Code and the related Treasury Regulations; that General could not successfully claim the federal tax benefits the PUC had expressly determined must be preserved; and that the order threatened to deprive General of its property without due process of law. General's petition for review and Pacific's companion petition were pending when the Revenue Service's rulings on the accelerated depreciation aspects of the PUC decision were issued to the two companies. They were immediately invited to the court's attention.

On July 13, 1978, the court below summarily denied the petitions for review. (App. A.) Thereafter the IRS issued its investment tax credit rulings. These too were filed with the court.

REASONS FOR GRANTING THE WRIT

In affirming the Public Utilities Commission's decision, the California Supreme Court has decided a federal question of substance that has not been and should be decided by this Court. The importance of that question to utility companies, ratepayers, regulatory agencies and the Federal Government cannot be overstated. Nothing less than the financial stability of the two utilities directly concerned and the integrity of telephone service in the most populous state in the union is immediately at stake. Beyond that, California's ex-

ample is likely to be followed by the regulatory bodies of at least some other states, so that utilities and their customers elsewhere in the nation will be similarly affected.

The question is urgent and is properly presented for decision by this Court at this time. Two of the three majority members of the five-member PUC have themselves urged a swift resolution of the question by this Court.

The state court decision on the federal question that has these immense and urgent implications is clearly wrong. The Internal Revenue Service has ruled that the California authorities erred in their construction of the governing federal statutory provisions administered by the IRS itself. There is no sound basis for questioning its judgment.

1. California is home to a tenth of the nation's people, and at least that proportion of the nation's telephones, telephone users and telephone service is found there. If the California Supreme Court erred in sustaining the judgment of the state's utilities commission as to what the federal tax law permits, the result in this large part of the country will be "service problems" and "staggering financial problems to be ultimately borne by" California ratepayers. (App. B, p. 22A.) The words are those of the Commission itself in describing the consequences of a miscalculation as to the tax effects of its decision, and they are, if anything, an understatement.

The Internal Revenue Service has already ruled that application of the PUC's accounting methods will destroy the eligibility of General and Pacific for accelerated depreciation and the investment credit. Such a

loss of eligibility would have both retroactive and prospective effect.

At the outset, General would face a current liability for back federal taxes of more than \$265,000,000. The combined liability of General and Pacific would amount to well over \$1 billion. Proceedings to enforce such liability would take some years. In the meantime, the PUC would continue to require application of its accounting methods, making the companies pass through to ratepayers the tax benefits that it says exist but whose existence the Revenue Service denies. General's and Pacific's rates would remain depressed, while their potential tax liability would mount.

The final judgments collected by the IRS could well total more than \$2 billion. The financial strain that such judgments would place on General and Pacific is obvious. As recognized by the PUC, "staggering rate increases" would be required to keep the utilities from financial collapse. The burden imposed on ratepayers and the dislocation of the regulatory system would be enormous.

Even then, the utilities would probably be unable to recoup more than a fraction of their loss. The PUC is barred by statute from engaging in retroactive rate-making; and, as a practical matter, it would be hard pressed to charge future ratepayers for the cost of a decade of improperly depressed rates. In short, the damage to these two companies that provide such a large proportion of the country's telephone service might be beyond repair.

The effects of the decision below will not be confined to California and its telephone companies and

users, serious as those effects are. Within California, other utilities and their customers will be affected.¹⁰ Elsewhere in the country, the work of the California PUC is watched closely by regulators if only because of its intrinsic importance arising from the size of the segment of the economy that it regulates. If the California PUC claims to have found a way to give its ratepayers a large part of the golden egg of flow-through without killing the accelerated depreciation goose, regulators in other states must pay attention. They may be persuaded by the legal arguments sketched in this petition that California has not found what it claims to have found. We would hope so. But they may not be persuaded, particularly if this Court denies the present petitions for review.

Looking at telephone service alone, every General telephone company and every telephone company in the Bell System is vulnerable. Each was using straight-line depreciation for all purposes in 1969, and each switched to accelerated depreciation after the Tax Reform Act of that year was enacted. Unlike the California companies, nearly all of the others received regulatory authorization to normalize tax expense as related to accelerated depreciation and to make a ratable flow-through of the investment credit. But those regulatory decisions can be altered. The prospect of a significant number of states risking "service problems" and "staggering financial problems" with their telephone systems by gambling as California has on the conformity of their accounting methods to the

¹⁰ Indeed, the PUC has already begun to apply the AAA and 2A methods to deal with the tax benefits of accelerated depreciation and the investment credit claimed by other utilities. See *Sierra Pacific Power Co.*, 23 P.U.R.4th 485, 489 (Cal. P.U.C. 1978).

Internal Revenue Code sections is frightening. And this does not even take into account the enormous consequences if gas, electric, and other utilities are similarly treated.

Finally, specific federal interests embodied in Sections 167(l) and 46(f) are threatened by the decision below. Congress wanted to ensure that the tax benefits of accelerated depreciation and the investment credit would be made available to utilities for capital investment and the creation of jobs rather than simply passed through to current ratepayers. If the PUC's decision is allowed to go into effect, that Congressional purpose will be frustrated.

Congress was also concerned about the *double* loss of federal tax revenues resulting from the "flow-through" technique as we have described it above. If the IRS is right about General's and Pacific's loss of eligibility, it will be able to recover the direct revenue loss attributable to the use of accelerated depreciation—at fearful cost to the companies and California telephone users—but it cannot recover the further, indirect loss resulting from the depressed rates caused by the PUC's improper flow-through of benefits.

2. This important question is properly presented for decision by the Court at this time. The issue, proper construction of a federal statute, is probably the most common kind of question with which this Court deals. The case is like many others in which the Court has reviewed decisions by state courts on issues of federal law that were the premises for ultimate state-law judgments. *See, e.g., Standard Oil Co. v. Johnson*, 316 U.S. 481 (1942), and *St. Louis, I.M. & S. Ry. v. Taylor*, 210 U.S. 281 (1908); and for recent examples see *California v. Byers*, 402 U.S. 424 (1971)

(review of question whether state's judicial rule restricting use of information, disclosure of which was compelled by state statute, was properly premised on Fifth Amendment privilege against self-incrimination); *Crane v. Cedar Rapids & I.C. Ry.*, 395 U.S. 164 (1969) (review of question whether defense of contributory negligence was available in state-law tort action premised upon violation of federal statute). See generally Greene, *Hybrid State Law in the Federal Courts*, 83 Harv. L. Rev. 289 (1969).

When state authorities choose, as the California commission and court did here, to rely upon and take advantage of federal statutory provisions, they are bound by the terms and conditions of those provisions as Congress has fashioned them and as this Court, ultimately, expounds them. Eligibility for the federal tax benefits in question can be maintained only if there is normalization and ratable flow-through as defined by federal law.¹¹

The question of the construction of the federal tax statutes has been squarely faced and decided by the

¹¹ Indeed, under § 167(l) a regulatory agency has no choice but to allow a utility to normalize its tax expenses, which alone makes it eligible for the tax benefits, or to recognize that, if the utility is ineligible for the benefits, its taxes will be based on straight-line depreciation. Congress meant to preclude regulatory agencies from imputing accelerated depreciation with flow-through. *Memphis Light, Gas & Water Division v. FPC*, 462 F.2d 853, 857 (D.C. Cir.), cert. denied on this point, 409 U.S. 941 (1972). S. Rep. No. 91-552, 91st Cong., 1st Sess. 173-74 (1969). Such imputation results if an agency makes rates on the presumption that the affected utility receives the tax benefits of accelerated depreciation, when in fact the utility is ineligible for those benefits. The same kind of improper imputation results when a utility's rates are calculated as if it were eligible for investment credits, but the utility is barred by § 46(f)(2) from taking such credits.

PUC, and its decision has been affirmed by the California Supreme Court. The Internal Revenue Service has formulated its judgment on the question, rejecting the PUC's position, in unequivocal terms. The record is complete; there are no open factual questions. The stage is thus properly set for this Court's review, and only review by this Court now can avert the disastrous consequences of the decision below.

3. The decision below on this urgent federal question is clearly wrong. The California authorities erred in construing Sections 167(l) and 46(f)(2) as allowing their novel ratemaking methods to be used without loss of eligibility for the benefits of accelerated depreciation and the investment credit. The rulings of the Internal Revenue Service remove any doubt that the PUC has misinterpreted the federal law. (App. D and E.)

a. Accelerated Depreciation and Normalization

As explained earlier, the purpose of the normalization requirement of Section 167(l) is to ensure that no portion of the tax benefits of accelerated depreciation is passed through to a utility's customers in the form of lower rates. (P. 7, *supra*.) A utility electing to use accelerated depreciation, therefore, is required under Section 167(l) to compute its expenses (which include tax expense) for ratemaking purposes as if it were using straight-line depreciation.¹² The amount of

¹² The definition of "normalization method of accounting" in § 167(l)(3)(G) does not explicitly require the use of straight-line depreciation for ratemaking purposes. Rather, it provides that utilities such as General must use "the same method of depreciation" to compute both the tax expense component and the depreciation expense component of their cost of service. Like most com-

tax deferred as a result of the utility's actual use of accelerated depreciation in computing taxes must be added to a reserve for deferred taxes. Int. Rev. Code § 167(l)(3)(G). Under Section 167(l)(3)(G), annual adjustments to the reserve must accurately reflect the tax deferrals for the year or other period for which ratemaking revenues and expenses are being computed. It is here that the AAA method adopted by the PUC, which has been described above (p. 12), fails the federal statutory test.

Obviously, if the regulatory commission fixing a utility's rates assumes a deferred tax reserve larger than the actual reserve for the period in which the utility's revenues and expenses are being measured and deducts that larger reserve from the rate base, the effect will be to reduce the utility's apparent revenue need and therefore its rates. The commission will thus be compelling the utility to pass through in lower rates a part at least of the benefits associated with accelerated depreciation. So to treat the benefits is plainly inconsistent with the statute.

This inconsistency is confirmed in the Treasury Regulations that spell out some of the rules implicit in the statute. Section 1.167(l)-1(h)(6)(i) of the Regulations provides:

“[A] taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate

missions, the PUC does not permit the use of accelerated depreciation (as opposed to straight-line depreciation) to calculate the depreciation component of a utility's cost of service. *See Tax Treatment of Accelerated Depreciation*, 33 P.U.R.3d 209, 219 (Cal. P.U.C. 1960).

of return is applied . . . exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking." (App. C, p. 88A.)

The AAA method would, by definition, result in just such an excessive exclusion from General's rate base as the quoted regulation forbids.¹²

An example set forth in the regulations speaks precisely to the AAA method. The example postulates a situation where "X" is a utility company involved in a ratemaking proceeding, with 1974 as the test year:

"The amount of the reserve for deferred taxes under section 167(l) at the end of 1974 is \$1,300,000 and the reserve is projected to be \$4,400,000 at the end of 1975, \$6,500,000 at the end of 1976, and \$9,800,000 at the end of 1977. X does not use a normalization method of regulated accounting if the Z Power Commission excludes more than \$1,300,000 from the rate base to which X's rate of return is applied." Treas. Reg. § 1.167(l)-1(h)(6) (iv). (App. C, p. 90A.) (Emphasis added.)

Thus, there is no doubt under federal law that the AAA method of accounting would destroy General's continued eligibility for accelerated depreciation.

¹² Under the AAA method, the PUC would determine General's cost of service and revenues for a single test year. The test year, then, is the period used in determining General's cost of service, including tax expense. However, instead of computing the rate base by deducting the amount in the tax reserve account during the test year, the PUC would deduct the higher average of the reserves estimated to be in the account over a four-year period (beginning with the test year). As a result, each year the AAA method would improperly flow through to General's ratepayers tax benefits that the statute and regulation expressly require General to reserve. (Under the PUC's calculations, the amount of flow-through in 1978, for example, would be approximately \$6.6 million. App. B, p. 58A.)

b. Investment Tax Credit and Ratable Flow-Through

The Congressional treatment of the investment tax credit is designed to ensure that, in ratemaking accounting, the credit is properly amortized over the life of the asset whose acquisition produced it, and that the benefit of the credit to the utility is not whittled down by reductions in rate base. Thus, Section 46(f)(2) of the Code, applicable to General, provides that the credit is not available if a utility's cost of service is reduced by more than a ratable portion of the credit (a portion related to the service life of the credit-producing asset)¹⁴ or if rate base is reduced at all by reason of the credit.

These conditions are not met by the PUC's 2A method. General's rate base and cost of service (reduced by a "ratable" portion of the investment credit then in effect) would be determined for the test year. Thereafter, in advance of each new year, an estimate would be made by the PUC of the amount of investment credit that General was expected to claim that year as the result of the acquisition or construction of new property. A ratable portion of such credit would then be deducted from General's cost of service, and rates would be adjusted accordingly.

The glaring flaw in this scheme is that increases in the tax credit after the test year would be deducted annually from General's cost of service, but no recognition would be given to the increased expenses incurred by General as a result of its increased investment. In particular, no recognition would be given to

¹⁴ For example, in a case where the service life of an asset was ten years and the investment credit was \$10,000, § 46(f)(2) would allow an annual ratable reduction in cost of service of \$1000.

the substantial depreciation expenses incurred by General arising from the very property additions that give rise to the new credits. Further, the related and appropriate increase in General's rate base would not be recognized.

The effect of freezing General's expenses and rate base at test-year levels—while annually deducting from cost of service a portion of estimated tax credits—is precisely the same as calculating General's expenses and rate base annually but then deducting more than the ratable amount of investment credit from cost of service. Either way, General's earned rate of return and its rates to its customers are artificially depressed. A portion of the tax benefits of the investment credit flows through to customers in the form of lower rates.¹⁵ The 2A method of ratemaking, therefore, is plainly inconsistent with Section 46(f)(2) of the Code.

The PUC recognized that the need to preserve eligibility for accelerated depreciation and the investment credit was the critical constraint on the kind of rate-making order it could fashion. It initially resisted pressures to deviate from the requirements of the Internal Revenue Code and Treasury Regulations because it appreciated that the price of flow-through was the loss of eligibility and that California's telephone users could not afford to pay that price. When it finally yielded, the PUC was unwilling to await the Internal Revenue Service's ruling, so that its methods could be tested against the IRS's authoritative judgment, before issuing its decision. It declined to defend its methods

¹⁵ In 1978 alone implementation of the 2A method would flow through some \$4.8 million in tax benefits. (App. B, p. 62A.)

in the IRS ruling process. Lastly, it chose to disdain the IRS rulings as adding "nothing new" when they were issued.

The doubts concerning its decision that the PUC manifested by its actions, if not its words, are fully warranted. The AAA and 2A methods are not even close to the statutory mark. They result in the flow-through of a substantial amount of the tax benefits of accelerated depreciation and the investment credit. Under the Internal Revenue Code provisions, the flow-through of *any part* of the benefits causes General and Pacific to lose their eligibility for *all* of the benefits. Thus, as a result of this partial flow-through, the PUC's methods threaten to cost the utilities well over a billion dollars in taxes that the PUC rate order assumes they will not have to pay. Ultimately, unless this Court intervenes now, it will be California's telephone users who will bear the burden of the PUC's grave misconstruction of federal tax law through higher rates and impaired service.

CONCLUSION

For the reasons stated, certiorari should be granted.

Respectfully submitted,

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